M. EMPLOYMENT TAX ISSUES INVOLVING EDUCATIONAL INSTITUTIONS

by
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Introduction

This article discusses employment tax issues involving educational institutions. First, this article describes agreements under section 218 of the Social Security Act (the "Act") and the recent legislation allowing states a limited window of time to amend their agreements to exclude from coverage services performed by students. Next, this article discusses guidance from the Service as well as recent litigation involving the Student FICA exception. Finally, this article discusses the income tax withholding requirements regarding payments made to foreign visiting scholars.

A. Section 218 Agreements

Prior to 1951, social security coverage was not available to employees of states and their political subdivisions. In 1951, Congress enacted section 218 of the Social Security Act, which allowed states to enter into agreements with the Social Security Administration (SSA) to provide for coverage under social security for state employees and employees of their political subdivisions. These agreements are commonly referred to as "section 218 agreements."

When a state enters into a section 218 agreement with the SSA, employees of the state and its political subdivisions are brought under the agreement in groups known as "coverage groups." For example, one possible coverage group is the employees of each institution of higher education. The Act gives each state the right to decide which coverage groups to include under its section 218 agreement. An agreement may be modified to increase the extent of coverage but generally may not be modified to reduce the extent of coverage. For wages paid after December 31, 1986, the Service determines liability for social security taxes under a section 218 agreement.

Section 2023 of Public Law 105-277 (the Balanced Budget Act), enacted October 21, 1998, provided an exception to the general rule that states may not amend their section 218 agreements to exclude certain groups from coverage. The legislation provided a limited window of time for states to modify their existing section 218 agreements to exclude services performed by students employed by the public school, college, or university where they are regularly attending classes. The legislation provides that to obtain this exclusion, the section 218 agreement must have been modified after December 31, 1998, and before April 1, 1999. Any modification made under this section will be effective with respect to services performed after June 30, 2000.

In addition to certain mandatory exclusions from coverage under a section 218

agreement, section 218(c) provides that certain services may be excluded from coverage upon election by the state. For example, under section 218(c)(5), a state has the option of excluding the services of students. But if a state chooses not to exclude student services under its agreement, those services will be covered under social security notwithstanding section 210(a)(10) of the Act, which provides for a general exclusion from social security coverage for services performed for a school, college or university by a student who is enrolled and regularly attending classes there. Section 210(a)(10) of the Act is the parallel provision to section 3121(b)(10) of the Code (the Student FICA exception).

A couple of law changes in recent years affect the employment taxation of state and local government entities generally. First, all state and local government employees hired after March 31, 1986, are automatically covered under the Medicare (HI) portion of the FICA, regardless of whether the state has a section 218 agreement. I.R.C. section 3121(u)(2). Second, effective July 2, 1991, all state and local government employees who are not covered under a qualified retirement system or a section 218 agreement are subject to mandatory social security and Medicare coverage. I.R.C. section 3121(b)(7)(F).

The Office of Employment Tax Administration and Compliance (OETAC) is providing oversight of an initiative to provide educational outreach to assist state and local employers in understanding their responsibilities under section 218.

B. The Student FICA Exception

Section 3121(b)(10) of the Code excepts from the definition of employment services performed in the employ of a school, college, or university (whether or not that organization is exempt from income tax), or an affiliated organization described in section 509(a)(3) of the Code, if the service is performed by a student who is enrolled and regularly attending classes at that school, college or university.

Section 31.3121(b)(10)-2 of the Employment Tax Regulations provides that whether an employee has the status of a student is determined on the basis of the employee's relationship with the school, college, or university for which the services are being performed. An employee who performs services in the employ of a school, college, or university as an incident to and for the purpose of pursuing a course of study at the school, college, or university has the status of a student in the performance of those services. If an employee has the status of a student, then the amount of remuneration for services performed by the employee, the type of services performed by the employee, and the place where the services are performed are immaterial for purposes of the Student FICA exception.

Eligibility for the Student FICA exception generally depends upon the facts and circumstances of each case. For this purpose, it is appropriate to focus on the nature of the individual's relationship with the school.

The Student FICA exception applies only if the student is employed by a school, college or university. Services performed by a student for any other employer do not qualify for this exception; the Student FICA exception does not apply with respect to services performed for a different employer, even though the work is in connection with the student's course of study. The status of a student's services therefore depends upon the identity of the of the actual common law employer for whom the services are performed. The common law employer is the person who has the authority to control and direct the individual who performs the services.

(1) Revenue Procedure 98-16

Revenue Procedure 98-16, 1998-5 I.R.B. 19, sets forth generally applicable standards for determining whether services performed by students in the employ of certain institutions of higher education qualify for the exception from FICA tax provided under section 3121(b)(10) of the Code. The standards contained in the Rev. Proc. are intended to be objective and administrable standards. However, the standards are not the exclusive methods for purposes of determining whether the Student FICA exception applies. Therefore, if the student does not meet the standards under the Rev. Proc., whether the Student FICA exception applies will depend on all the facts and circumstances.

For purposes of Rev. Proc. 98-16, the term "institution of higher education" includes any public or private nonprofit school, college, university, or affiliated organization described in section 509(a)(3) of the Code that meets the requirements set forth in Department of Education regulations at 34 C.F.R. section 600.4 (1997) (requires, e.g., that the institution admit only high school graduates and be authorized by the State to provide a post-secondary educational program) and that is accredited or preaccredited by a nationally recognized accrediting agency as defined in the Department of Education regulations at 34 C.F.R. section 600.2 (1997).

Rev. Proc. 98-16 provides that career employees are not eligible for the Student FICA exception because their employment cannot generally be considered to be incident to and for the purpose of pursuing a course of study. Under the Rev. Proc., the term "career employee" includes an individual who (1) is eligible to participate in the employer's retirement plan; (2) is eligible to receive an allocation of employer contributions other than contributions described in section 402(g) of the Code under an arrangement described in section 403(b) of the Code, or would be eligible to receive such allocations if age and service requirements were met, or if contributions described in section 402(g) of the Code were made by the employee;

(3) is eligible for reduced tuition (other than qualified tuition reduction under section 117(d)(5) of the Code provided to a teaching or research assistant who is a graduate student) because of the individual's employment relationship with the institution; or (4) is classified by the institution of higher education as a career employee.

The Rev. Proc. provides certain standards applicable in determining whether undergraduate or graduate students are eligible for the Student FICA exception. An individual who is a half-time undergraduate student or a half-time graduate or professional student and who is not a career employee will qualify for the Student FICA exception. But the half-time requirement need not be met in cases where a student is in the last semester, trimester, or quarter of a course of study requiring at least two semesters, trimesters, or quarters to complete and the student is enrolled in the number of credit or unit hours needed to complete the requirements for obtaining a degree, certificate, or other recognized educational credential offered by that institution of higher education even if enrolled in less than half the number required of full-time students.

The Rev. Proc. further provides that the Student FICA exception does not apply to services performed by an individual who is not enrolled in classes during school breaks of more than five weeks (including summer breaks of more than five weeks). See Rev. Rul. 72-142, 1972-1 C.B. 317, and Rev. Rul. 74-109, 1974-1 C.B. 288. However, the Student FICA exception applies to employment which continues during normal school breaks of 5 weeks or less, even though the student is not attending classes during the break, provided the student met the half-time requirement before the break and is eligible to enroll in classes after the break.

a. The University of Minnesota Case

Rev. Proc. 98-16 provides that the standards contained in the Rev. Proc. do not apply to the treatment of postdoctoral students, postdoctoral fellows, medical residents, or medical interns because services performed by these employees cannot be presumed to be for the purpose of pursuing a course of study. However, the status of medical residents was at issue in State of Minnesota v. Apfel, 151 F.3d 742 (8th Cir. 1998). In State of Minnesota, the court addressed whether medical residents enrolled in the graduate medical education program at the University of Minnesota (University) are covered under the State's section 218 agreement. In State of Minnesota, the SSA appealed the district court's grant of the State's motion for summary judgment. In granting the State's motion, the district court relied on alternative grounds. First, it held that the medical residents were not "employees" of the University within the meaning of the State's section 218 agreement. Alternatively, the district court held that, even if the residents were employees under the terms of the agreement, they were excluded from coverage under the agreement's student exclusion.

The appellate court first considered whether the medical residents were "employees" within the meaning of the State's section 218 agreement. In 1958, the State executed a modification to its original section 218 agreement to extend coverage to "employees" of the

University. For more than 30 years, the University did not withhold or pay FICA on annual stipends paid to medical residents. The court found that the section 218 agreement for coverage and the 1958 amendment were "contractual arrangement[s]." Accordingly, it held that the meaning of the section 218 agreement cannot be altered through ruling by the SSA or through subsequent case law developments regarding the employment status of medical residents, and thus, in the absence of change by Congress, the parties original intent controls. Finding that the State did not intend to cover medical residents when it amended its section 218 agreement in 1958, the court concluded that the medical residents were not covered under the agreement.

The court went on to considered whether, even if the medical residents were considered "employees" under the terms of the 1958 modification, the residents were nevertheless excluded from coverage under the agreement's student exclusion. The modification excluded "any services performed by a student" as permitted under section 218(c)(5) of the Act. The student exclusion under section 218(c)(5) of the Act provides that "such agreement shall, if the State requests it, exclude (in the case of any coverage group) any agricultural labor, or service performed by a student, designated by the State." 42 U.S.C. section 418(c)(5). Section 218(c)(5) cross-references the Act's general student exclusion under section 210(a)(10), which applies to service performed in the employ of a school, college, or university "if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." 42 U.S.C. section 410(a)(10). The language of section 210(a)(10) of the Act is identical to the language of section 3121(b)(10) of the Code.

The court held that it was not determinative that the stipends are paid for services performed; rather, the critical inquiry is the nature of the relationship between University and the medical residents. The court cited section 20 C.F.R. section 404.1028(c), which provides that "[w]hether you are a student for purposes of this section depends on your relationship with your employer. If your main purpose is pursuing a course of study rather than earning a livelihood, we consider you to be a student and your work is not considered employment." Compare Treas. Reg. section 31.3121(b)(10)-2(c) ("[a]n employee who performs services in the employ of a school, college, or university, as an incident to and for the purpose of pursuing a course of study ... has the status of student").

The court held that it is necessary to examine all the facts and circumstances to determine whether the services were performed as an incident to and for the purpose of pursuing a course of study. The court found persuasive the facts that the residents are enrolled at the University, pay tuition, and are registered for approximately fifteen credit hours per semester; although they provide patient services while working at the hospital, it does not necessarily follow that they are enrolled primarily to earn a livelihood. Moreover, the court held that the fact that the payments to the residents are taxable income does not mean that the primary purpose of the relationship with the University is not educational. Thus, the court concluded that the primary

purpose for the residents' participation in the program is to pursue a course of study rather than to earn a livelihood. Accordingly, the services performed by the medical residents fell within the student exclusion under the State's section 218 agreement. The SSA acquiesced to the decision in State of Minnesota. Social Security Acquiescence Ruling 98-5 (8), 63 F.R. 58444.

It has been suggested that the Student FICA exception applies to all medical residents as a result of the State of Minnesota decision. However, as in all cases, the applicability of the exception depends on the facts and circumstances.

The medical resident must be a student and the services must be performed in the employ of the educational institution at which the resident is a student. In this regard, facts to be developed in a case involving this issue include whether the medical resident is enrolled at an educational institution and registered for credit and whether the student is required to pay tuition. In addition, if a medical resident is employed by an employer other than the educational institution, such as a hospital, the Student FICA exception will not apply. Moreover, even if an educational institution pays a medical resident and reports the resident's compensation on Form W-2, the Student FICA exception may nevertheless be unavailable if the educational institution is not the employer based upon the common law standard.

C. Reimbursements of Expenses of Foreign Visiting Scholars

The issue has arisen whether section 1441 (withholding of tax on nonresident aliens) of the Code requires that income tax be withheld from payments to reimburse foreign visiting scholars for travel and other expenses incurred in visiting an institution of higher education located within the United States.

Section 871(a)(1)(A) of the Code provides that nonresident aliens are taxed at the rate of 30% on certain types of U.S. source gross income that are not effectively connected with the conduct of a U.S. trade or business. Section 1441(a) provides that the tax is to be collected by the person making the payment at the time the payment is made to the nonresident alien. The reimbursements for travel and living expenses (treated as remunerations or emoluments) of foreign visiting scholars are included within the types of gross income subject to the tax and withholding under section 1441(b) of the Code. These laws are applicable to foreign visiting scholars unless an exclusion from income is provided by another section of the Code or a tax treaty.

Section 61(a)(1) of the Code provides that gross income means all income from whatever source derived, including compensation for services. Section 62(a)(2)(A) provides that the term "adjusted gross income" means gross income minus the expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.

Section 62(c) of the Code provides that an arrangement shall not be treated as a

reimbursement or other expense allowance arrangement if such arrangement does not require the employee to substantiate the expenses covered by the arrangement or if such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 1.62-2(c)(1) of the regulations provides that the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section. Section 1.62-2(c)(2)(i) of the regulations provides that if an arrangement meets the requirements of paragraphs (d), (e), and (f), all amounts paid under the arrangement will be treated as paid under an "accountable plan."

Under section 1.62-2(c)(4) of the regulations, amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. See also sections 31.3121(a)-3(a), 31.3306(b)-2(a), and 31.3401(a)-4(a) of the Employment Tax Regulations. If an arrangement does not meet each of the requirements under paragraphs (d), (e), and (f) of section 1.62-2, section 1.62-2(c)(3)(i) of the regulations provides that the amounts paid under the arrangement will be treated as paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are treated as wages subject to employment taxes under regulation section 1.62-2(c)(5).

Section 1.62-2(d)(1) of the regulations provides that an arrangement meets the business connection requirement of this paragraph if it provides advances, allowances (including per diem allowances), or reimbursements only for business expenses that are allowable as deductions under Part VI (sections 161 through 196), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer.

Section 1.62-2(e) of the regulations provides that an arrangement meets the substantiation requirement if the arrangement requires each business expense to be substantiated to the payor within a reasonable period of time. An arrangement that reimburses travel, entertainment, or other deductible expenses governed by section 274(d) of the Code meets this requirement if information sufficient to satisfy the substantiation requirements of section 274(d) and the regulations thereunder is submitted to the payor. Section 1.274-5T(b)(2) of the regulations provides that the elements to be substantiated with respect to an expenditure for travel away from home are amount, time, place, and business purpose.

The third requirement of an accountable plan, provided under 1.62-2(f), is satisfied if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the substantiated expenses. The

determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend upon the facts and circumstances.

If an arrangement meets the three requirements, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with regulations, the amount paid under the arrangement that is in excess of the substantiated expenses is treated as paid under a nonaccountable plan. Treas. Reg. section 1.62-2(c)(3)(ii).

If a foreign visiting scholar is acting as an independent contractor with respect to services performed for a host university, expense reimbursements will not qualify as payments made under an accountable plan because the accountable plan rules only apply to employees. However, for purposes of working condition fringe benefits, which are excludible from the income of "employees" under section 132(a)(3), the term "employee" includes any independent contractor who performs services for the employer. Treas. Reg. section 1.132-1(b)(2).

Section 132(d) defines the term "working condition fringe" as any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 (trade or business expense) or section 167 (depreciation expense).

Under section 1.132-5(a)(1)(v), a cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to (A) use the payment for expenses in connection with a specific or prearranged activity or undertaking for which a deduction is allowable under section 162 or section 167, (B) verify that the payment is actually used for such expenses, and (C) return to the employer any part of the payment not so used.

Section 1.132-5(a)(1)(ii) of the regulations provides that if, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or section 167 to be allowable, then those substantiation requirements apply when determining whether a property or service is excludible as a working condition fringe.

Section 1.274-5T(h) of the regulations provides rules for the reporting and substantiation of certain expenses for travel, entertainment, gifts, or with respect to listed property paid or incurred by one person (hereinafter termed "independent contractor") in connection with services performed for another person (hereinafter termed "client or customer") other than an employer under a reimbursement or other expense allowance arrangement with such client or customer.

Section 1.274-5T(h)(2) provides that an independent contractor shall substantiate, with respect to his reimbursement, each element of an expenditure (described in section 1.274-5T(b)) in accordance with the requirements of section 1.274-5T(c); and, to the extent he does not so substantiate, he shall include such reimbursements in income.

To summarize, if a foreign visiting scholar is acting in the capacity as an employee of another entity (e.g., an employee of a foreign university), and the reimbursements are in connection with the performance of services as an employee of the employer under sections 62(a) and (c) and the relevant regulations, the fact that the reimbursements are paid by a third party (e.g., the host university) is not determinative, provided that the foreign visiting scholar's employer maintains an accountable plan. Consequently, if the nonresident alien's employer maintains an accountable plan within the meaning of section 1.62-2(c)(2), the reimbursements for substantiated expenses are excluded from the individual's income, are not reported as wages or other compensation on the individual's Form W-2, and are exempt from the withholding and payment of employment taxes.

Alternatively, if the nonresident alien participated in the conference in connection with a separate trade or business (i.e., as an independent contractor), the reimbursements are not governed by sections 62(a) and (c). However, section 132(a)(3) and the regulations thereunder exclude from income the cash payments to reimburse expenses if the individual properly substantiated expenses incurred to the payor and if the reimbursements do not exceed those substantiated expenses. If these requirements are met, reimbursements paid to foreign visiting scholars are not subject to withholding.